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The Manufacturers Hanover
# Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JANUARY 1981

## Quarterly Business Conditions Analysis

I do not consider myself a contrarian. That is—I do not deliberately take a view opposite to everyone else just to be different. However, when it comes to economic forecasting—especially in recent years—a little bit of contrariness does not seem to hurt. Indeed, if one were to have forecasted the opposite of the general view on the economy and the financial markets during 1980, one's accuracy might have been significantly enhanced.

It is with this in mind that I view the consensus forecast for 1981 a bit suspiciously. The general feeling is that, after a slow start in the first half, the economy will pick up speed in the second. The rate of inflation will gradually decelerate under this scenario, although remaining uncomfortably high by yearend. Interest rates should fall somewhat during the year, but like the rate of inflation, also remain uncomfortably high. In other words—the consensus view for 1981 represents a playing out of the business cycle which began a year or so ago. Quite naturally, this view assumes that no new unusual external shocks will hit the economy and that the new Administration will be able to achieve some (but not all) of its economic objectives.

Such a scenario does not sound unreasonable to me. As a matter of fact, it is the one that I depict in the gross national product forecast table located elsewhere in this Report. For this forecast to stand a chance of coming true, however, several assumptions have to be made. The first is that the new Administration will modify somewhat its fiscal policy stance projected during the election campaign. That is—it will delay cutting personal taxes, cutting only business taxes to spur investment. Also, it will not boost defense spending much beyond what has already been projected. This would leave us with a budget deficit in the current fiscal year of somewhere in the $55-60 billion zone, and one in fiscal year 1982 half that or less.

On the monetary side, the Federal Reserve is assumed to continue to try to achieve its long-standing objectives of promoting relatively slow growth in the money and credit aggregates without precipitating either a credit squeeze or generating a new round of inflation and the expectation of inflation. The various definitions of the money supply are assumed to grow within their announced target ranges, and not gyrate wildly as was the case in 1980. Externally, better luck is assumed regarding the weather, food prices and the price of oil than was the case in 1980. This projection also assumes no major strikes in the United States and no significant change in the value of the dollar against the currencies of our major trading partners. In a word, it is a rather sanguine view of the outlook which looks for a much calmer economic and financial scene both in the U.S. and worldwide this year than was the case in chaotic 1980.

Maybe it's because I am so shell-shocked from the unusual events of 1980, but I just don't think things are going to fall into place so neatly. I think Murphy's Law ("If something can go wrong it will") is still alive and well. Thus, I am mindful of the many external shocks that could hit the economy this year, throwing it onto one of two alternate paths: deep recession (with a rapid slowing of inflation and sharp declines in interest rates) or no recession at all (with inflation and interest rates taking off for the stratosphere before very long). Let me take these two alternative scenarios one at a time and develop the line of reasoning behind each.

**The Case For A Deep Recession . . .**

It is very possible that we may be on the brink of a rather sizable recession. To be sure, I don't mean one as sharp as the one that occurred during second-quarter 1980. Rather, I mean one more typical in nature, with the gross national product adjusted for inflation dropping at annual rates of three to four per cent per quarter for two or three quarters. Even by recent standards, this magnitude of decline in economic activity would have some slowing effect on the rate of inflation, thus bringing down interest rates as well.

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The tendencies for the economy to lapse into such a recession are certainly present. For one thing, buying power of the typical family has been cut significantly by a combination of events. The first is that prices of oil have gone up in the past few months. Since October, the average price of oil we import has gone from $33.83 per barrel to $36.31 per barrel—an increase of 7.3 per cent. In addition, the cold winter in many parts of the country has caused households to consume much more in the way of oil and other fuels as well, thereby further increasing their fuel costs and leaving them less money to spend for everything else. The weather has also affected food supplies and prices. While we have yet to feel the full effects of last year's drought in the Farm Belt, we now have the effects of a freeze in the Southeast to contend with as well. This undoubtedly will boost food prices even further, again draining buying power. Finally, Social Security taxes went up 5.6 per cent on January 1, reducing take-home pay commensurately.

Aside from these factors, there are other indications that the economy may be poised for a renewed downturn. For one thing, the important automobile and homebuilding industries are sluggish. Housing starts fell 25 per cent in 1980 compared with 1979, while sales of domestically-produced autos dropped 21 per cent. With various attitude surveys showing consumer buying plans down, it is unlikely that these industries in particular, or consumer durables in general, will show any improvement any time soon, and past experience indicates that it is very difficult for the economy to mount a recovery if this sector is in the doldrums.

The business side does not look any better, either. The latest survey of purchasing agents shows the biggest shift in new orders in any single month since World War II, causing purchasing executives to turn pessimistic. Not surprisingly, machine tool ordering is down, while the Government's latest survey of capital investment plans shows only a slight increase in expenditures on new plants and equipment after factoring out inflation. Such a development is not surprising, in view of the fact that "real" interest rates (nominal interest rates minus the rate of inflation) are at a record high. This means that the real cost of money is higher than the real rate of return likely to be garnered from putting these borrowed funds to use.

These arguments alone do not guarantee that the economy will lapse into recession. It might take one or two unusual shocks for this to happen. While not predicting any of these, several come to mind which could well trigger such a downturn. The first deals with monetary policy. Knowingly or unknowingly, the Federal Reserve could overstay its policy of monetary restraint. That is—the Fed could keep draining reserves from the banking system in order to prevent interest rates from falling in response to the slowing economy so as to avoid a repetition of the roller coaster swings in interest rates in 1980. Needless to say, this might starve the economy for liquidity, causing spending by both businessmen and consumers to be cut back, thereby producing recession. As part of this, one or two major business bankruptcies might well shock people into pulling in their horns because of new uncertainties. There could always be a development in the Middle East that would result in a significant cutback in oil supplies to the industrialized world, which would have a negative impact on the U.S. economy for obvious reasons.

**. . . And For None At All**

On the other hand, it is entirely possible that the economy will skirt recession altogether, and because of this, the rate of inflation might accelerate, pulling up interest rates with it. For just as there are some statistics that depict weakness in the economy, there are others that suggest just the opposite. What is more, these latter statistics seem to be more in concert with the recent tendencies of the U.S. economy to turn out to be stronger than anticipated. For one thing, the leading economic indicators rose for six months in a row toward the end of 1980. The Conference Board's index of help-wanted advertising jumped 17 percentage points in three months. Not surprisingly, first-time claims for unemployment insurance at the end of 1980 were down to their second lowest weekly level in ten months. And while retail sales dipped a bit in December, they had climbed during the previous five months—enough to help most businessmen get bulging inventories back into better shape.

There are other factors as well. While autos and housing have indeed tumbled, they are probably not as important to the economy as they used to be. For example, ten years ago expenditures on motor vehicles and parts amounted to nearly seven per cent of total consumer spending. By the end of last year, that percentage had declined to about 4¾ per cent. Consumer spending on furniture and household equipment similarly fell from six per cent of total personal consumption expenditures ten years ago to 5.3 per cent today, while residential fixed investment has dropped from 31 per cent of total gross private domestic investment ten years ago to 27 per cent currently.

There are other factors that should make us think twice before anticipating weakness in the coming months. For example, there may be more purchasing power out there than economists generally think. This was demonstrated by the Government's recent revision of the gross national product statistics which, among other things, elevated the savings rate by 0.7 percentage point, or $9.2 billion, for the past

ten years. Then there is the so-called "underground" economy, consisting of funds earned but not declared, thus not in the personal income statistics. Like the black hole in space, the underground economy can not be seen, but its presence is no doubt being felt in the form of this latent economic strength that economists keep underestimating.

In addition to this, I think I have found another source of buying power that until now may have eluded economists. It seems to me that any family that earns more than it spends is bound to come out ahead even if prices go up about the same as its income. This is because the same percentage increase is applied to the larger income base, yielding a bigger gain in dollars than the rise in the cost of goods bought. And, progressive tax brackets notwithstanding, enough families are in this position, since there are savings for the consumer sector as a whole. Furthermore, when you consider that even the best measure of inflation does not reflect the market basket of goods and services that the typical family purchases, it is entirely possible that while economists bemoan the impact of inflation on people's buying power, in actual dollars, there is more money available to be spent than meets the eye.

The monetary statistics should also be looked at very carefully when determining how much liquidity is in the economy to finance continued growth. The shift to nationwide negotiable order of withdrawal (NOW) accounts on January 1 means that more money will be available for immediate spending than might have been the case previously, when much of these funds were "locked up" in savings accounts, thus less likely to be touched. Another addition to spending power will undoubtedly come from fiscal policy. Projections by the Carter and Reagan Administrations notwithstanding, the facts are that the budget deficit so far in the current fiscal year is running at an annual rate of over $65 billion—without any tax cut.

Of course, all this potential buying power will not keep the economy out of recession unless it is utilized. One factor that I can think of which might get people to increase their rate of spending is a reappearance of inflation psychology. I don't mean the kind that existed a year ago, which drove prices of precious metals to the moon. Rather, I mean the kind that shows up in everyday purchases, as people remember the attitudes they first developed in the spring of 1978: Prices are not likely to stop rising regardless of who is in power. Personally, I think many people have already come to this conclusion, but I would look for this to intensify if several other developments were to appear on the national scene. If oil prices were to take off once again where the price of oil at the wellhead were to reach $50 a barrel in short order, if the 12-month rise in food prices, now around ten per cent, were to escalate to, say, 15 per cent, if major contract settlements called for wage increases to reach 12 per cent from last year's 9.5 per cent, if a war involving the U.S. should break out any place or if personal taxes were to be cut retroactive to January 1, I would expect inflation psychology to heat up, producing a burst of consumer (and business) spending, thereby keeping the economy from lapsing into recession.

**Conclusions**

I hope after reading this far you have begun to share my suspicion of the consensus view of the economy for 1981. Much as I would like to see the rather sanguine outlook described earlier and in the GNP table, I have learned from experience to expect the unexpected. It is too soon to tell which path the economy will take, but if you keep watch for the shocks I described earlier, you might get an early clue.

Of course, things don't unfold as neatly as I described above. That is—it is always possible that a combination of external shocks might hit the economy that would simultaneously tend to retard economic activity while at the same time boosting inflation and the expectation of inflation. As a matter of fact, we could already be heading toward such conflicting exogenous factors. For example, it does appear as though the Federal Reserve is erring on the side of monetary tightness. Even though the money supply has been flat on balance since the middle of the fourth quarter and loan demand at commercial banks has weakened somewhat, the Federal Reserve has not allowed the Federal funds rate to decline very much. This could be in response to several factors, but I would bet that one of them is the latent strength that the economy continues to exhibit.

You need look no further than the fourth quarter's figures on the gross national product to see what I mean. The fact that the economy could grow at a five per cent annual rate in the fourth quarter with interest rates approaching record highs and automobiles and housing in the doldrums is nothing short of phenomenal. When you add to this the very real possibility that the Administration will cut taxes, you can see where the potential for a collision of forces exists, and why I am reluctant to put all of my eggs in one forecast basket, so to speak.

But if I have to stick my neck out, I would guess that the rate of inflation and interest rates will be higher than many people now anticipate while the economy will be stronger in real terms as well. This is because it's going to take a lot more restraint than the Federal Reserve has already dished out in order to bring the economy down. At the same time, more and more people have not only learned to live with high rates of inflation and high rates of interest—some even look forward to it. In my next Report I will discuss who these people are and what their attitudes are doing to our national will to fight inflation and bring interest rates down. H

**January, 1981**

**MHT FORECAST OF GROSS NATIONAL PRODUCT**

**(Seasonally Adjusted Annual Rates)**

**In $ Billions**

| | | | < ACTUAL | | | | | | PROJECTED > | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | YEAR 1979 | | 1980 | | | | YEAR 1980 | | 1981 | | | | YEAR 1981 | |
| | LEVEL | % CH | I | II | III | IV | LEVEL | % CH | I | II | III | IV | LEVEL | % CH |
| Gross National Product | **2413.9** | **12.0** | 2571.7 | 2564.8 | 2637.3 | 2741.4 | **2628.8** | **8.9** | 2807.9 | 2882.9 | 2969.3 | 3062.6 | **2930.7** | **11.5** |
| GNP: $72 | **1483.0** | **3.2** | 1501.9 | 1463.3 | 1471.9 | 1490.1 | **1481.8** | **−0.1** | 1486.7 | 1489.1 | 1496.5 | 1505.8 | **1494.5** | **0.9** |
| % Change, Annual Rates | **3.2** | | 3.1 | −9.9 | 2.4 | 5.0 | **−0.1** | | −0.9 | 0.7 | 2.0 | 2.5 | **0.9** | |
| Consumption | **1510.9** | **12.0** | 1631.0 | 1626.8 | 1682.2 | 1744.4 | **1671.1** | **10.6** | 1793.4 | 1847.2 | 1908.7 | 1968.8 | **1879.5** | **12.5** |
| Durables | **212.3** | **6.5** | 220.9 | 194.4 | 208.8 | 222.1 | **211.5** | **−0.4** | 224.1 | 232.5 | 240.9 | 250.1 | **236.9** | **12.0** |
| Non-Durables | **602.2** | **13.7** | 661.1 | 664.0 | 674.2 | 697.8 | **674.3** | **12.0** | 718.6 | 737.2 | 762.7 | 785.0 | **750.9** | **11.4** |
| Services | **696.4** | **12.4** | 749.0 | 768.4 | 799.2 | 824.5 | **785.3** | **12.8** | 850.7 | 877.5 | 905.0 | 933.7 | **891.7** | **13.6** |
| Investment | **415.8** | **10.8** | 415.6 | 390.9 | 377.1 | 403.7 | **396.8** | **−4.6** | 412.6 | 427.6 | 440.2 | 457.7 | **434.5** | **9.5** |
| Non-Residential | **279.7** | **15.6** | 297.8 | 289.8 | 294.0 | 297.3 | **294.7** | **5.4** | 302.6 | 310.1 | 316.0 | 329.2 | **314.5** | **6.7** |
| Producers Durable Equipment | **183.4** | **12.3** | 189.7 | 181.4 | 186.8 | 188.0 | **186.5** | **1.7** | 190.7 | 195.0 | 198.6 | 205.1 | **197.3** | **5.8** |
| Structures | **96.3** | **22.4** | 108.2 | 108.4 | 107.3 | 109.3 | **108.3** | **12.5** | 111.9 | 115.2 | 117.4 | 124.2 | **117.2** | **8.2** |
| Residential | **118.6** | **6.6** | 115.2 | 93.6 | 99.2 | 112.2 | **105.0** | **11.4** | 111.1 | 113.9 | 117.7 | 123.9 | **116.6** | **11.0** |
| Inventory Changes | **17.5** | | 2.5 | 7.4 | −16.0 | −5.7 | **−2.9** | | −1.1 | 3.5 | 6.5 | 4.6 | **3.4** | |
| Net Exports | **13.4** | | 8.2 | 17.1 | 44.5 | 34.5 | **26.1** | | 31.1 | 28.5 | 26.6 | 23.3 | **27.4** | |
| Government Purchases | **473.8** | **9.5** | 516.8 | 530.0 | 533.5 | 558.8 | **534.8** | **12.9** | 570.8 | 579.6 | 593.7 | 612.7 | **589.2** | **10.2** |
| Federal Defense | **111.2** | **11.3** | 125.0 | 128.7 | 131.4 | 142.7 | **132.0** | **18.7** | 146.2 | 149.6 | 153.3 | 161.2 | **152.6** | **15.6** |
| Federal Civilian | **56.7** | **6.1** | 64.9 | 70.0 | 63.5 | 70.6 | **67.3** | **18.6** | 70.4 | 68.2 | 68.9 | 70.6 | **69.5** | **3.4** |
| State & Local | **305.9** | **9.6** | 326.8 | 331.3 | 338.6 | 345.5 | **335.5** | **9.7** | 354.2 | 361.8 | 371.5 | 380.9 | **367.1** | **9.4** |
| Final Sales: $72 | **1472.8** | **3.5** | 1502.8 | 1462.0 | 1476.9 | 1490.3 | **1483.0** | **0.7** | 1487.3 | 1487.7 | 1493.7 | 1503.9 | **1493.1** | **0.7** |
| % Change, Annual Rates | **3.5** | | 3.1 | −10.4 | 4.1 | 3.7 | **0.7** | | −0.8 | 0.1 | 1.6 | 2.7 | **0.7** | |
| GNP Price Index (1972 = 100) | **162.8** | **8.5** | 171.2 | 175.3 | 179.2 | 184.0 | **177.4** | **9.0** | 188.9 | 193.6 | 198.4 | 203.4 | **196.1** | **10.5** |
| % Change, Annual Rates | **8.5** | | 9.3 | 9.8 | 9.2 | 11.2 | **9.0** | | 11.1 | 10.4 | 10.3 | 10.4 | **10.5** | |
| PCE Deflator (1972 = 100) | **162.3** | **8.9** | 172.9 | 177.0 | 180.7 | 185.0 | **178.9** | **10.2** | 190.2 | 195.2 | 200.3 | 205.2 | **197.8** | **10.5** |
| % Change, Annual Rates | **8.9** | | 12.2 | 9.8 | 8.6 | 9.9 | **10.2** | | 11.8 | 11.0 | 10.8 | 10.2 | **10.5** | |
| Consumer Price Index (1967 = 100) | **217.6** | **11.3** | 237.1 | 244.8 | 249.1 | 256.4 | **246.8** | **13.4** | 264.3 | 271.9 | 279.0 | 286.1 | **275.3** | **11.5** |
| % Change, Annual Rates | **11.3** | | 16.9 | 13.7 | 7.2 | 12.3 | **13.4** | | 12.9 | 12.0 | 10.9 | 10.6 | **11.5** | |
| Total Personal Income | **1943.8** | **12.9** | 2088.2 | 2114.5 | 2182.1 | 2259.1 | **2161.0** | **11.2** | 2315.3 | 2377.1 | 2456.6 | 2519.3 | **2417.1** | **11.9** |
| Disposable Personal Income | **1641.7** | **12.2** | 1765.1 | 1784.1 | 1840.6 | 1899.1 | **1822.2** | **11.0** | 1942.5 | 1991.2 | 2088.5 | 2138.2 | **2040.1** | **12.0** |
| Savings Rate | **5.3** | | 4.9 | 6.2 | 6.1 | 5.6 | **5.7** | | 5.2 | 4.8 | 6.2 | 5.6 | **5.4** | |
| Employment Rate | **58.3** | | 58.3 | 57.6 | 57.5 | 57.4 | **57.7** | | 57.4 | 57.3 | 57.7 | 57.9 | **57.6** | |
| Unemployment Rate | **5.8** | | 6.1 | 7.5 | 7.6 | 7.5 | **7.2** | | 7.7 | 7.9 | 7.7 | 7.5 | **7.7** | |
| Indus. Production (1967 = 100) | **152.5** | **4.4** | 152.5 | 144.6 | 142.1 | 148.9 | **147.0** | **−3.6** | 147.8 | 147.7 | 150.3 | 153.9 | **149.9** | **2.0** |
| Housing Starts (000) | **1721.9** | **−14.3** | 1263.3 | 1053.0 | 1411.7 | 1556.0 | **1321.0** | **−23.3** | 1314.2 | 1422.9 | 1479.0 | 1542.0 | **1439.6** | **9.0** |
| Domestic Auto Sales (000) | **8230.1** | **−10.2** | 7922.3 | 5488.0 | 6497.0 | 6668.3 | **6643.9** | **−19.3** | 6634.5 | 7008.6 | 7163.7 | 7445.4 | **7063.0** | **6.3** |
| Corporate Pre-Tax Profits | **255.3** | **14.4** | 277.1 | 217.9 | 237.6 | 248.1 | **245.2** | **−4.0** | 220.7 | 230.2 | 238.5 | 246.7 | **234.0** | **−4.5** |
| − Taxes | **87.6** | **5.6** | 94.2 | 71.5 | 78.5 | 80.3 | **81.1** | **−7.4** | 74.0 | 78.6 | 82.0 | 85.1 | **79.9** | **−1.5** |
| Net Profits | **167.8** | **19.5** | 182.9 | 146.5 | 159.1 | 167.8 | **164.1** | **−2.2** | 146.8 | 151.6 | 156.4 | 161.7 | **154.1** | **−6.1** |
| − Dividend Payments | **48.6** | **12.8** | 52.4 | 54.2 | 55.1 | 56.1 | **54.5** | **12.0** | 58.0 | 60.0 | 62.3 | 64.5 | **61.2** | **12.4** |
| Undistributed Profits | **117.6** | **22.9** | 128.9 | 90.7 | 102.4 | 111.7 | **108.4** | **−7.8** | 88.7 | 91.6 | 94.2 | 97.2 | **92.9** | **−14.3** |
| + Depreciation | **139.5** | **13.6** | 151.7 | 155.4 | 160.5 | 165.3 | **158.2** | **13.4** | 196.3 | 200.3 | 204.9 | 209.4 | **202.7** | **28.1** |
| − Inventory Profits | **42.6** | **75.4** | 61.4 | 31.1 | 41.7 | 38.9 | **43.3** | **1.5** | 47.7 | 57.0 | 59.4 | 57.8 | **55.5** | **28.2** |
| Net Cash Flow | **214.5** | **10.4** | 219.2 | 215.0 | 221.2 | 238.1 | **223.4** | **4.1** | 237.3 | 234.9 | 239.6 | 248.8 | **240.1** | **7.5** |